No. 95-1402

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR RESPONDENT

DAVID D. AUGHTRY
Counsel of Record
SHELLEY CASHION
DAVID W. SIEGEL
Of Counsel
CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN
Attorneys for Respondent
1400 Harris Tower
233 Peachtree Street, N.E.
Atlanta, Georgia 30303-1507
(404) 659-1410

8588
Lutz Appellate Services, Inc.
(800) 3 APPEAL • (800) 5 APPEAL • (800) BRIEF 21
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QUESTION PRESENTED

Whether payment of some of the post-mortem estate administration expenses out of post-mortem income of an estate reduces the value of date-of-death corpus actually passing to charitable and marital beneficiaries under 26 U.S.C. §§ 2055 and 2056, when payment from post-mortem income is permitted by state law and the controlling testamentary documents.

TABLE OF CONTENTS

	Page
Question Presented	i
Table of Contents	ii
Table of Citations	iv
Opinions Below	1
Statement of Jurisdiction	1
Statutes and Regulations Involved	1
Statement of the Case	3
Summary of Argument	12
Argument	16
1. The Statutory Scheme Provides Symmetry for Valuing Property Included in and Distributed by an Estate, as Well as a Choice to Deduct Post-Death Expenses on Either the Estate Tax Return or the Estate's Income Tax Return.	16
2. Hindsight Plays No Part in Determining the Date-of-Death Value of Property Included in the Gross Estate and the Date-of-Death Value of Property Distributed to Marital and Charitable Legatees.	19

Contents

	Page
3. The Holdings of the Tax Court and the Eleventh Circuit Produce the Only Result Which Is Consistent with the Purposes of the Marital and Charitable Estate Tax Deductions.	22
4. As the Commissioner Has Argued Successfully Before, State Law Determines Property Rights.	25
5. No Difference Should Exist Between an Estate Which Is Able to Promptly Distribute Its Assets into Trust and One Which Is Not.	31
6. Neither the Case Principally Relied Upon by the Commissioner in This Court, *United States v. Stapf*, nor Reg. § 20.2056(b)-4(b) Requires that Authorized Payments of Administration Expenses from Post-Mortem Income Reduce the Marital and Charitable Deductions Dollar-for-Dollar.	32
a. The Commissioner Places Her Principal Reliance Upon a "Real Value" Argument Deprived from *United States v. Stapf*, Which Does Not Relate to This Area of the Law.	33
b. Under the Commissioner's Gift and Estate Tax Regulations and Rulings, Which Are Expressly Invoked by § 2056(b)(4)(B), Payment of Administration Expenses Does Not Result in a Diminution of Corpus Passing to the Spouse.	37

Page

c. The Commissioner's New Interpretation of a Permissive Example in a Valuation Regulation Is Entitled to No Deference from This Court. 41

7. The Tax Court's Fact Findings Preclude an Examination of the Legal Issue Raised by the Commissioner. 45

Conclusion 49

TABLE OF CITATIONS

Cases Cited:

Alston v. United States, 349 F.2d 87 (5th Cir. 1965) 12, 14, 18, 25, 26, 42

Ballantine v. Tomlinson, 293 F.2d 311 (5th Cir. 1961) 12, 15, 18, 25, 26, 33, 34, 42

Blair v. Commissioner, 30 U.S. 5 (1937) 28

Brimberry v. Commissioner, 588 F.2d 975 (5th Cir. 1979) 42

Bull v. United States, 295 U.S. 247 (1935) 4, 14, 20

Burke v. United States, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 510 U.S. 990 (1993) 33, 44, 45

Page

California v. ARC America Corp., 490 U.S. 93 (1989) .. 30

California v. FERC, 495 U.S. 490 (1990) 30

Citizens & Southern Nat'l Bank v. Haskins, 254 Ga. 131, 327 S.E. 2d 192 (1985) 11, 39

Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) . 28

Commissioner v. Stern, 357 U.S. 39 (1958) 31

Ernest & Mary Hayward Weir Foundation v. United States, 362 F. Supp. 928 (S.D.N.Y. 1973), *aff'd*, 508 F.2d 894 (2d Cir. 1974) 30

Estate of Bennett v. Commissioner, 100 T.C. 42 (1993) . 29

Estate of Casey v. Commissioner, 948 F.2d 895 (4th Cir. 1991) 28

Estate of Gilford v. Commissioner, 88 T.C. 38 (1987) .. 20

Estate of Lee v. Commissioner, 11 T.C. 141 (1948), *acq.*, 1948-2 C.B. 3 29

Estate of Richardson v. Commissioner, 89 T.C. 1193 (1987) 29, 36, 43

Estate of Roney v. Commissioner, 33 T.C. 801 (1960), *aff'd per curiam*, 294 F.2d 774 (5th Cir. 1961) 12, 14, 15, 18, 25, 26, 34, 42, 46

Page

Estate of Snider v. Commissioner, 84 T.C. 75 (1985) ... 29

Estate of Street v. Commissioner, 974 F.2d 723 (6th Cir. 1992), *aff'g in part and rev'g in part*, 56 T.C.M. (CCH) 774 (1988) 11, 33, 34, 36, 43, 44

Estate of Vissering v. Commissioner, 990 F.2d 578 (10th Cir. 1993) 28

Estate of Warren v. Commissioner, 981 F.2d 776 (5th Cir. 1993) 12, 25, 27, 28, 42

Estate of Watson v. Commissioner, 94 T.C. 262 (1990) . 29

Estate of Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987) 25

Fisher v. United States, 28 Fed. Cl. 88 (1993) 44

Guilzon v. Commissioner, 985 F.2d 819 (5th Cir. 1993) . 42

Harrison v. Northern Trust Co., 317 U.S. 476 (1943) .. 20

Hunter v. United States, 597 F. Supp. 1293 (W.D. Pa. 1984) 28, 29

Jackson v. United States, 376 U.S. 503 (1964) 28

Maass v. Higgins, 312 U.S. 443 (1941) 4, 13, 20

McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972) 23

Page

Morgan v. Commissioner, 309 U.S. 78 (1940) 28, 30

Neill v. Phinney, 245 F.2d 645 (5th Cir. 1957) 27

NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937) 25

Paige v. Henry J. Kaiser Co., 826 F.2d 857 (9th Cir. 1987), *cert. denied*, 486 U.S. 1054 (1988) 30

Republic Nat'l Bank of Dallas, Trustee v. Commissioner, 334 F.2d 348 (5th Cir. 1964) 42

Riggs v. Del Drago, 317 U.S. 95 (1942) 26

Trust Servs. of America, Inc. v. United States, 885 F.2d 561 (9th Cir. 1989) 20

United States v. Edmondson, 331 F.2d 676 (5th Cir. 1964) 28

United States v. Stapf, 357 U.S. 118 (1963) ... 15, 32, 33, 34, 35

United States v. Traders Nat'l Bank, 248 F.2d 667 (8th Cir. 1957) 26, 28

Walter v. United States, 341 F.2d 182 (6th Cir. 1965) ... 20

Statutes Cited:

26 U.S.C. § 212 ..... 5, 6, 17

Page

26 U.S.C. § 641(b) 17

26 U.S.C. § 642(g) 5, 6, 18, 25

26 U.S.C. § 2001 ..... 4, 16

26 U.S.C. § 2031 ..... 4, 16

26 U.S.C. § 2031(b) 47

26 U.S.C. § 2053 18

26 U.S.C. § 2053(a)(2) 5, 6, 36

26 U.S.C. § 2054 18

26 U.S.C. § 2055 i

26 U.S.C. § 2055(a) 4, 6, 7, 22, 23, 24, 36, 37

26 U.S.C. § 2055(d) 17, 36

26 U.S.C. § 2056 i

26 U.S.C. § 2056(a) 4, 6, 17, 22, 23, 24, 36, 37

26 U.S.C. § 2056(b)(4) 41

26 U.S.C. § 2056(b)(4)(B) 15, 18, 35, 36, 37, 40, 46, 47

26 U.S.C. § 2056(b)(9) 36

Page

28 U.S.C. § 1254(1) 1

GA. CODE ANN. § 53-15-3 5

Rules Cited:

TAX COURT RULES OF PRACTICE & PROCEDURE 91 ..... 6, 7

TAX COURT RULES OF PRACTICE & PROCEDURE 142(a) 6

Other Authorities Cited:

26 C.F.R. § 20.2031-(b) 46, 47

26 C.F.R. § 20.2031-2(f) 47

26 C.F.R. § 20.2055-1(a) 17

26 C.F.R. § 20.2056(b)-4(a) 9, 11, 17, 37, 41, 46

26 C.F.R. § 20.2056(b)-4(b) 32, 35

26 C.F.R. § 20.2056(b)-5(f) 1

26 C.F.R. § 20.2056(b)-5(f)(1) 39

26 C.F.R. § 20.2056(b)-5(f)(4) 10, 37, 38, 39

26 C.F.R. § 20.2056(b)-7(d)(2) 10, 37

26 C.F.R. § 25.2523(e)-1(f) 2, 38, 47

Page

26 C.F.R. § 25.2523(e)-1(f)(1) 38

26 C.F.R. § 25.2523(e)-1(f)(3) 39

26 C.F.R. § 25.2523(e)-1(f)(4) 38

Rev. Rul. 66-21, 1966-1 C.B. 219 29

Rev. Rul. 69-56, 1969-1 C.B. 223 ..... 10, 40

Rev. Rul. 69-193, 1969-1 C.B. 222 29

Rev. Rul. 76-369, 1976-2 C.B. 281 29

Rev. Rul. 78-419, 1978-2 C.B. 244 29

Rev. Rul. 79-252, 1972-2 C.B. 333 11

Rev. Rul. 88-12, 1988-1 C.B. 330 29

Rev. Rul. 93-48, 1993-2 C.B. 270 ..... 1, 36, 44

H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938) 23

S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981), *reprinted in* 1981-2 C.B. 412 ..... 16, 22

S. Rep. No. 1013, 80th Cong., 2d Sess. II-6, *reprinted in* 1948-1 C.B. 331 44

Page

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Pamela C. Champine, *Paying Administrative Expenses Out of Income Attributable to Marital and Charitable Residuary Bequests: Double Dipping or Appropriate Accounting?* 14 Va. Tax Rev. 507 (1995) 31

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Scott H. Malin & Bennett S. Keller, *Planning for the Allocation of Administration Expenses to Income Under Hubert*, 84 J. Tax'n 213 (1996) 31

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David Pratt, *Deducting Estate Administration Expenses: Does a Section 642(g) Election Still Make Sense?*, 65 Tax Notes 1683 (1994) 31

Jacques T. Schlenger, Robert E. Madden & Lisa H.R. Hayes, *Administration Expenses Payable from Income Do Not Reduce Marital and Charitable Deductions*, 23 Est. Planning 30 (1996) 31

George L. Strobel II & Caroline D. Strobel, *The Proper Treatment of Administrative Expenses: The Debate Rages On*, 27 Tax Adviser 228 (1995) 31

Contents

Page

Note, *Tax Law: Administrative Expenses and the Charitable and Marital Deductions — The Potentially Painful Surprise of a 642(g) Deduction — Estate of Hubert v. Commissioner*, 20 U. DAYTON L. REV. 501 (1994) 31, 33

Note, *The Role of State Law in Federal Tax Determinations*, 72 HARV. L. REV. 1350 (1959) 30

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eleventh Circuit (CIR Pet. at 1a-23a)[1] is reported at 63 F.3d 1083. The reviewed opinion of the United States Tax Court (CIR Pet. at 26a-79a) is reported at 101 T.C. 314.

STATEMENT OF JURISDICTION

The judgment of the court of appeals affirming the reviewed decision of the Tax Court was entered on September 12, 1995. Petitioner ("the Commissioner") filed a petition for rehearing with suggestion for rehearing en banc on October 27, 1995, which was denied on December 5, 1995. (CIR Pet. at 24a-25a.) The Commissioner then filed a petition for a writ of certiorari on March 1, 1996, which was granted on April 29, 1996. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

In addition to those cited in the Commissioner's brief (at 2-5):

1. 26 C.F.R. §§ 20.2056(b)-5(f) provides in relevant part:

> **Marital deduction; life estate with power of appointment in surviving spouse.** . . . (f) *Right to Income.* (1) If an interest is transferred in trust, the surviving spouse is "entitled for life to all of the income

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1. Citations to "CIR Pet." or to "CIR Br." are to the self-contained appendix in the Petition for a Writ of Certiorari or to the Brief on the merits, respectively, for Petitioner Commissioner of Internal Revenue. Citations to "Jt. App." are to the Joint Appendix of the parties filed simultaneously with the Commissioner's Brief on the merits.

from the entire interest or a specific portion of the entire interest," . . . if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust . . . .

(4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust [for want of entitlement to "all of the income"] unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . .

2. 26 C.F.R. § 25.2523(e)-1(f) provides in relevant part:

> **Marital deduction; life estate with power of appointment in donee spouse** . . . . (f) *Right to Income.* (1) If an interest is transferred in trust, the donee spouse is "entitled for life to all of the income from the entire interest or a specific portion of the

entire interest," . . . if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust . . . .

(4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest transferred in trust [for want of entitlement to "all of the income"] unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus . . . .

STATEMENT OF THE CASE

This case concerns the estate tax liability of the Estate of Otis C. Hubert, who was a resident of Georgia at his death. He died in July of 1986, leaving an estate divided almost equally between his family and charity. (CIR Pet. at 3a.)

1. Upon the death of a decedent who has sufficient property value to invoke the estate tax, his "gross estate," less various

deductions, is subject to tax. 26 U.S.C. § 2001.[2] The amount of the gross estate is determined by the value of the decedent's property "at the time of his death." § 2031. Congress chose to permit bequests to charity and to the decedent's surviving spouse to pass free of estate tax and therefore provided deductions from the gross estate known as the "charitable deduction" and the "marital deduction." The measure of these deductions is the value of the property passing to charity and to the surviving spouse as of the date of the decedent's death. §§ 2055(a), 2056(a). In determining these values, neither the date-of-death value of the property going into an estate nor the date-of-death value of that same property going out of an estate is embellished by post-death income of the estate. Such values would then no longer be "date-of-death." *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941); *Bull v. United States*, 295 U.S. 247, 256-257 (1935). The object of these date-of-death valuations is to provide a uniform standard for measuring the property that comes into the estate and the property that leaves the estate, providing symmetry from an inclusion and deduction standpoint.

2. Mr. Hubert's Will left the residue of his estate in trust, the income of which was to be paid to his wife, with the remainder to charity. One of three codicils removed a general power of appointment that had been granted to Mr. Hubert's wife in his Will. That codicil led to a Will contest. After four years of litigation among Mr. Hubert's family, his nephew (who drafted the Will and codicils) and statutory representatives of the charitable beneficiaries, the Cobb County Probate Court entered an Order which disposed of the residuary estate in a manner different than the Will and codicils. In lieu of the Will and codicils, the Order implemented the Second and Final Settlement Agreement, dividing the entire residuary estate into

2. Hereafter, except as otherwise stated, all citations to "§" are to the Internal Revenue Code of 1954, 26 U.S.C., as amended and effective for decedents dying in July of 1986, and all citations to "Reg. §" are to the Treasury Regulations on Estate and Gift Tax, 26 C.F.R.

two parts (the "Marital Share" and the "Charitable Share") and designating a specific amount of residuary to be paid to the Marital Share, with the remainder flowing to the Charitable Share under a "pour-over" provision. Thus, the entire residuary went to either the Marital Share or the Charitable Share. The Marital and Charitable Shares included both estate corpus in existence as of the date-of-death and post-death income earned on that corpus. Just as post-death income had been allocated between the two Shares by agreement among adverse parties, so also were post-death administration expenses allocated between the Marital and Charitable Shares. The date-of-death value of the residuary corpus to be divided between the Marital Share and the Charitable Share was $26,224,436. (Jt. App. at 39¶50, 52¶22.)

Under Georgia probate law, an executor may charge payments of administration expenses either against the income of the estate or against corpus, if the Will so provides. GA. CODE ANN. § 53-15-3 (MICHIE 1982). In this case, Mr. Hubert's Will authorized the executor "to charge any expenses against income or principal or apportion the same." Acting pursuant to this authority in the Will, the executor charged $506,989 of administration expenses against corpus, and as permitted by § 2053(a)(2), those charges were deducted from the gross estate on the estate tax return. All other administration expenses were charged by the executor against the post-death income earned by the Hubert Estate. As permitted by the Internal Revenue Code, the executor elected to relinquish the deduction of those administration expenses against corpus on the estate tax return and instead deducted those administration expenses from post-death income on the estate's income tax returns (Forms 1041). §§ 212, 642(g).[3]

3. The Commissioner states that between 1986 and 1991, the Estate's income exceeded $4.5 million and that the Estate's administration expenses exceeded $2 million. (CIR Br. at 8.) That assertion is both misleading and inaccurate. In fact, the Estate's Forms 1041 for the years ended May 31, 1987 (Cont'd)

In accordance with the dictates of §§ 2055(a), 2056(a) and 2053(a)(2), the executor of the Hubert Estate reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of administration expenses charged against corpus, since those expenses reduced the amount of the date-of-death corpus which the beneficiaries actually received. Because administration expenses that accrued after Mr. Hubert's death and were paid from income earned by the estate did not and could not reduce either the date-of-death valuation of the corpus included in the gross estate or the date-of-death corpus which the beneficiaries actually received, the executor did not make such a reduction for the administration expenses charged against post-death income. Instead, the executor deducted those expenses on the estate's income tax returns pursuant to §§ 212 and 642(g).

3. After issuing a notice of estate tax deficiency on grounds not before this Court, the Commissioner raised a new issue on the eve of the Tax Court trial setting. She contended that the marital and charitable deductions had been overstated by the total administration expenses, without regard to the source of their payment, the effect of state law or the effect of any elections made by the executor. Thus, the Commissioner contended that administration expenses properly paid from estate income reduced the date-of-death values of the charitable and marital bequests. Because this new issue was not set forth in the notice of estate tax deficiency, the Commissioner bore the burden of proof on all factual matters, including the effect, if any, on value of payment of administration expenses with post-death income of the estate. TAX COURT RULES OF PRACTICE & PROCEDURE 142(a).

Pursuant to Rule 91, TAX COURT RULES OF PRACTICE &

(Cont'd)
through May 31, 1990 (the last return filed prior to the Stipulation of Facts), which are part of the Tax Court record, show income of $5,207,865 and administration expenses of $1,140,114, a spread of over $4 million.

PROCEDURE, all parties must stipulate all fact matters to the fullest extent possible; "[t]he Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part . . . ." Based upon the date-of-death values, the residuary estate was $26,224,436 (Jt. App. at 39 ¶ 50, 52 ¶ 22):

Gross Estate	$30,254,219
Specific Bequests:	
Spouse	(220,747)
Churches	(400,000)
Other	(30,000)
Schedule J Deductions (Administration Expenses)	(506,989)
Schedule K Deductions (Debts)	(2,472,047)
Estate Tax	(400,000)[4]
Total Residuary Estate (Corpus)	$26,224,436

The Commissioner's stipulations, when adjusted for the imputed interest argument she lost and did not appeal, result in the sum of the marital and charitable deductions exceeding the whole of the residuary. As corrected for the implicit issue she lost, the Commissioner stipulated that the "Allowable Residuary Marital Deduction" and the "Charitable Deduction per [the Commissioner]" were (Jt. App. at 42 ¶ 57, 43 ¶ 58):[5]

4. Because of an uncontested change in the marital deduction QTIP election, a portion of the taxes paid on the estate tax return may be subject to refund and taxed instead in Mrs. Hubert's estate. Any refund would increase the residuary and be divided between the Marital and Charitable Shares.

5. The actual stipulations were that the marital deduction was $11,896,597 and the charitable deduction was $11,840,385 flowing from the residuary. In these stipulations, the Commissioner reduced the marital and charitable deductions by interest she deemed had been implicitly earned on the assets of Mr. Hubert's estate — by $2,847,541 and $3,098,001, respectively. The Tax Court refused to condone the Commissioner's concept of imputed interest , and the Commissioner did not appeal this determination.

"Allowable Residuary Marital Deduction"	$11,896,597
Reversal of Implicit Interest Adjustment	2,847,541
Allowable Residuary Marital Deduction (Corrected)	$14,744,138
Charitable Deduction Per [the Commissioner]	$11,840,385
Reversal of Implicit Interest Adjustment	3,098,001
Charitable Deduction Per Commissioner (Corrected)	$14,938,386

Since the sum of the parts exceeds the whole, that is, the sum of the $14,744,138 marital and $14,938,386 charitable deductions exceeds the $26,224,436 date-of-death residuary corpus, the Commissioner here seeks guidance from this Court on a position which will have no financial impact upon this tax case.

The Commissioner's position was that as a matter of law, the executor must be viewed as having charged expenses against corpus as of the date of death, thereby reducing the value of the

(Cont'd)

However, the proper amount of the date-of-death residuary corpus flowing to the Marital Share is calculated as follows (Jt. App. at 35¶43, 36¶44, 42¶57):

Second and Final Settlement	*Calculation*
¶10a.(1)	$ 14,390,000
¶10a.(1) and 17(a)	183,175
¶10a.(2)	699,376
Subtotal Marital Share	$ 15,272,551
Reductions:	
¶10a.(1)(B) (Marital Income)	($ 1,219,603)
¶10a.(2) (Marital Income)	(699,376)
Deduction – Corpus	$ 13,353,572

(Cont'd)

passing property dollar-for-dollar by the entire amount of the administration expenses. In this Court, the Commissioner puts a different spin on this position, urging that in order to determine the "real value" of the charitable and marital bequests, the date-of-death value of this property must be reduced dollar-for-dollar for estate distribution purposes (although not for inclusion purposes) by the full amount of any expenses ultimately paid with income. (CIR Br. at 19.) Nevertheless, the Commissioner put on no evidence whatsoever of the effect on the date-of-death value of the residuary property passing to the spouse and to charity resulting from the contingent event that the executor might charge administration expenses against corpus. Nor did the Commissioner put on any evidence as to the effect of this contingency on the date-of-death value of that same property for estate inclusion purposes.

4. The en banc Tax Court held that the marital and charitable deductions were not reduced by post-death administration expenses properly allocated to post-death income pursuant to Georgia law and Mr. Hubert's controlling testamentary documents. (CIR Pet. at 50a.) The Commissioner had relied primarily on permissive language in a marital deduction valuation regulation which listed payment of administration expenses from income as an example of an instance in which an encumbrance might exist on a marital bequest. Reg. § 20.2056(b)-4(a). Although the Commissioner read the regulation as an inviolate rule, the Tax Court opined that

(Cont'd)

The remainder of the residuary corpus (excluding post-death income) passes to the Charitable Share by way of a pour-over provision. The amount of that corpus is (Jt. App. at 35-36¶44, 43¶58):

Date-of-Death Residuary — Corpus	$ 26,224,436
Allocated to Marital — Corpus	(13,353,572)
Balance to Charity — Corpus	$ 12,870,864

it merely set forth a permissive example of a situation in which the rule *may* be applied, if the proof of value shows that it is factually applicable. Based on the facts of the case, the Tax Court found that the right to pay administration expenses out of post-death income was not a material limitation on the right of the surviving spouse to receive that income. (CIR Pet. at 40a-41a.) The Commissioner did not appeal this fact-finding.

Further, the Tax Court pointed out that the regulation relied upon by the Commissioner, as well as its statutory origins, directed that the value of the interest passing to the spouse, if encumbered, be determined "as if the amount of a gift to the spouse were being determined." (CIR Pet. at 41a.) The Tax Court pointed out that the Commissioner's own gift tax rulings had long held that payment of administration expenses out of income is not a limitation on the spouse's right to income. Further, on the facts of this case, the Tax Court found that no substantial limitation on Mrs. Hubert's right to income existed, a fact-finding which the Commissioner has not appealed. (CIR Pet. at 41a, *citing* Rev. Rul. 69-56, 1969-1 C.B. 223.)

This reading is the only one which harmonizes all of the Commissioner's regulations, including Reg. § 20.2056(b)-5(f)(4), with the governing statute. This regulation addresses the marital deduction when, as here, the spouse receives a life estate with a general power of appointment,[6] and it specifically addresses the "right to income" when the executor is given the discretion to pay expenses out of income. The regulation states that "the power to determine the allocation or apportionment of receipts and disbursements between income and corpus" is not a condition which will cause the spouse to have a right to less than

6. Under the settlement agreement, the Marital Share is divided between the general power of appointment trust and a qualified terminal interest trust. Principles identical to those contained in Reg. § 20.2056(b)-5(f)(4) are applied to a qualified terminal interest trust by Reg. § 20.2056(b)-7(d)(2).

"all of the income," as required by a general power of appointment trust, "if the local courts will impose reasonable limitations upon the exercise of powers." (CIR Pet. at 42a.) Those "reasonable limitations" exist under Georgia law. *Citizens & Southern Nat'l Bank v. Haskins*, 254 Ga. 131, 327 S.E.2d 192 (1985).

The Tax Court also rejected the Commissioner's contention that the legislative history of the marital deduction dealing with payment of claims out of an estate's post-death income requires a reduction of the marital deduction when administration expenses are paid out of that income. (CIR Pet. at 42a.) This legislative history nowhere refers to administration expenses. The Tax Court pointed out that claims against an estate are in existence at the date of death and thus burden the estate's corpus, but administration expenses arise after death and may relate to both corpus and post-death income. Logically, administration expenses may thus be charged to either post-death income or to corpus, while claims must be charged to corpus.

The Tax Court expressly disagreed with the contrary prong of the Sixth Circuit's decision in *Estate of Street v. Commissioner*, 974 F.2d 723, 727 (6th Cir. 1992), *aff'g in part and rev'g in part*, 56 T.C.M. (CCH) 774 (1988).[7] (CIR Pet. at

7. *Estate of Street* had two parts: (i) with respect to interest on estate taxes, the court held that such administration expenses, when allocable to post-mortem income, do not reduce the marital and charitable deductions because the interest expense accrues after death, and estate income used to pay these expenses would not affect the date-of-death value of the estate; (ii) with respect to other post-mortem administrative expenses, allocable to income, the charitable and marital deductions would be reduced dollar-for-dollar because of the example set forth in Reg. § 20.2056(b)-4(a). 974 F.2d at 729. The Commissioner has now agreed with the *Estate of Street* position as to interest on estate taxes. Rev. Rul. 93-48, 1993-2 C.B. 270. Whether other administration expenses can be differentiated from estate tax interest expenses is the subject of this case. Rev. Rul. 79-252, 1972-2 C.B. 233.

46a.) The Tax Court disagreed with the Sixth Circuit's analysis that income earned by the estate increases the Marital Share and so expenses paid out of that income must reduce the marital deduction. That analysis proceeds on the false assumption that the Marital Share and the marital deduction are one and the same. Consistent with this critical factual distinction established by the Tax Court in its first footnote (CIR App. at 27a n.1), the Marital Share includes both the date-of-death corpus and post-mortem income, whereas the marital deduction only includes the date-of-death corpus. The Tax Court noted that income earned on estate property is not included in the gross estate, and "as a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate." (CIR Pet. at 46a-47a.)

5. The court of appeals adopted the Tax Court's opinion as its own. (CIR Pet. at 1a-23a.) In doing so, the court of appeals noted that Georgia law authorizes the allocation of expenses to income, rather than principal, if the Will so provides. For this reason, the court reconciled and embraced prior precedents, which also followed the requirements of state law with respect to whether administration expenses should be charged against corpus. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961). Finally, the court of appeals noted that the Fifth Circuit (the author of these three opinions) agreed with the Tax Court. In *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993), the Fifth Circuit held that the allocation of administration expenses to income as allowed by state law does not reduce the charitable deduction. (CIR Pet. at 2a-3a.)

SUMMARY OF ARGUMENT

This federal estate tax dispute focuses upon the division of the corpus of the residuary estate between the surviving spouse

and charity. There is no dispute as to the amount of the date-of-death value of the residuary corpus, for that is uncontroverted. Nor is there any dispute that, in determining this corpus, the Hubert Estate properly allocated a portion of post-mortem administration expenses to corpus and properly allocated the remainder to post-mortem income under the authority of the controlling testamentary documents and state probate law: that is stipulated. There is also a stipulation that the Second and Final Settlement Agreement (which settled a four-year Will contest) is binding here for federal estate tax purposes. Finally, there is no dispute that this agreement controls the actual flow of the residuary property and divides the entire residuary corpus between the surviving spouse and charity. The Commissioner simply wishes to create a disappearing residuary by way of a federal fiction that $26,224,436 of corpus comes into the residuary but only $24,294,375 goes out to the surviving spouse and to charity. The Commissioner then seeks to tax this disappearing residuary. As 15 out of 17 Tax Court judges and the majority of the United States Court of Appeals for the Eleventh Circuit held, that attempt is flawed for at least seven reasons:

1. The sum of the parts should equal the whole of the residuary corpus. The federal estate tax system is built upon a concept of symmetry, by measuring the property coming into an estate under the same standards that it measures property flowing out of the estate. For both inclusion and distribution purposes, the federal estate tax system uses fair market value as of the date of the decedent's death. In this way, what comes in goes out: the estate balances.

2. In order to be true to this standard, one cannot succumb to the temptation to indulge in hindsight. Both the Tax Court and the Eleventh Circuit relied upon this Court's directive in *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941), for the critical principle that post-mortem income earned by the estate cannot

enhance the date-of-death value of property coming into the gross estate. *Accord, Bull v. United States*, 295 U.S. 247, 256-257 (1935). It follows that since post-mortem income makes up no part of the gross estate and since the gross estate is the starting point for computing deductions to arrive at the taxable estate, post-mortem expenses paid from that post-mortem income under the authority of the Will and state law cannot decrease what has not been increased — the date-of-death value of the corpus.

3. The conclusion reached by the Tax Court and the court of appeals is the only result consistent with the overriding purposes of the charitable and marital estate tax deductions. Since 1981, the purpose of the marital deduction has been to permit a deferral of estate tax on property passing to the surviving spouse until the death of the second spouse, recognizing that husband and wife constitute a single "economic unit." Hence, Congress provided for a full marital deduction with the expectation that there would generally be no tax on the first estate. By comparison, Congress has always encouraged charity by excluding charitable contributions from estate tax. If a generous citizen leaves his or her entire estate to charity, Congress intended that the charity should receive that entire estate with no diminution by federal estate taxes. Likewise, if a citizen divides his or her estate entirely between charity and the surviving spouse, no tax is ever incurred on the part left to charity, and the tax on the part left to the spouse is deferred until her death. Thus, the Commissioner's position in this case is an attempt to create tax when none was intended by Congress by exploiting the delays caused by the Will contest and this tax litigation.

4. The Commissioner successfully urged reliance on state probate law in the three cases on which all of the appellate authority in this area is based, since state law operated to her financial advantage in those cases. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 294

F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961). In each of those cases, the Commissioner argued that state law determined whether date-of-death corpus or post-mortem income bore the obligation of post-mortem administration expenses. Once the flow of property was determined, federal law was applied. Now the Commissioner wants to change her mind. However, only her original approach can be reconciled with the 40 years of precedent on this issue. Indeed, every commentator post-*Estate of Hubert*, save a student note, has concluded that the Tax Court and the Eleventh Circuit are correct.

5. The federal estate tax and income tax treatment endorsed by the Estate, the Tax Court and the Eleventh Circuit is also buttressed by the reality that such treatment is precisely what the Commissioner would require had the Estate been able to promptly close into trusts. The delay caused by the period of administration simply does not change date-of-death values.

6. For the first time in the eight-year history of this case, the Commissioner places her primary reliance on a "real value" argument, citing a case not urged by her in her Petition for Certiorari or even cited by the courts below. The case cited by the Commissioner, *United States v. Stapf*, 375 U.S. 118 (1963), is a *quid pro quo* case and has no application to the question before this Court. *Stapf* applies only to "obligations" or "encumbrances" imposed by the decedent which result in a purported legatee having to effectively purchase property from the estate. Post-mortem administration expenses properly borne by post-mortem income create no obligation or encumbrance on corpus within the meaning of §2056(b)(4)(B). Moreover, the gift tax standards invoked by that statute recognize that costs of administration may be borne by income when adequate allocation protection is afforded by state law. Finally, the Commissioner's new interpretation of a 40-year-old regulation, one that conveniently ignores the permissive nature of the

example contained therein, is entitled to no deference from this Court.

7. The essence of the Commissioner's new position is a valuation dispute, which is inherently a factual matter. Challenge of the Tax Court's fact-findings is barred by the Commissioner's stipulations, her failure to introduce any evidence despite having the burden of proof, and her failure to appeal the fact-findings against her.

ARGUMENT

1. The Statutory Scheme Provides Symmetry for Valuing Property Included in and Distributed by an Estate, as Well as a Choice to Deduct Post-Death Expenses on Either the Estate Tax Return or the Estate's Income Tax Return.

The federal estate tax system proceeds on the basis of symmetry. That symmetry is achieved by including property in the gross estate using the same standard and the same valuation date as are applied against that same property upon distribution. Thus, upon the death of a decedent dying with sufficient property to invoke the estate tax, his or her "gross estate," less various deductions, is subject to that tax. §2001. The amount of the gross estate is determined by the value of the decedent's property "at the time of his death." § 2031 ("the value of the gross estate of the decedent shall be . . . the value at the time of his death"); § 2033 ("[t]he value of the gross estate shall include the value of all property . . . of the decedent at the time of his death").

To implement the congressional policy treating husband and wife as one economic unit,[8] property passing to the surviving

8. "[A] husband and wife should be treated as one economic unit for purposes of estate and gift taxes. . . ." S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981), *reprinted in* 1981-2 C.B. 412, 461.

spouse is deducted from the gross estate. § 2056(a). The measure of this "marital deduction" is the value of the property passing to the surviving spouse "as of the date of decedent's death," if the value of such property "is included in determining the value of the gross estate." § 2056(a); Reg. § 20.2056(b)-4(a). Similarly, to effect the congressional goal of encouraging charitable giving, the gross estate is reduced by charitable contributions, with the measure of those contributions being "the value of property included in the decedent's gross estate," *i.e.*, the date-of-death value. § 2055(a); Reg. § 20.2055-1(a). Again, the amount of the deduction from the gross estate for transfers to charity "shall not exceed the value of the transferred property required to be included in the gross estate." § 2055(d). The object of these date-of-death valuations is to provide a uniform standard for measuring the property that comes into the estate and the property that leaves the estate, so that symmetry from an inclusion and deduction standpoint will exist.

The death of a decedent, opening and administration of his or her estate, distribution of assets to beneficiaries, and resolution of claims is a process that often occupies a span of time. As a consequence, many estates — especially complicated estates or those drawn into litigation — will be required to file and pay income taxes on their net income during the period of administration of the estate. This requirement is set forth in Subchapter J of the Internal Revenue Code, entitled *Estates, Trusts, Beneficiaries, and Decedents.*

During the period that an estate is being administered, it will incur administration expenses. Since, for income tax purposes, Subchapter J of the Internal Revenue Code subjects estates and trusts to the provisions applicable to individuals, estates and trusts are thereby authorized to deduct administration expenses for income tax purposes. §§ 641(b), 212. The Subchapter J rules grant the estate the freedom of deducting administration expenses on the estate's income tax return (Form 1041), subject

to certain restrictions. If, as here, the administration expenses are reported on the Form 1041, the estate is reporting the same numbers in the same income tax return and on the same form it would have used had the estate been able to close promptly into trust.

First, however, to deduct administration expenses for income tax purposes, the estate's fiduciary must relinquish the right otherwise granted by §§ 2053 and 2054 to deduct those same administration expenses on the estate tax return (Form 706).[9] § 642(g). Thus, § 642(g) precludes the double deduction of the same administration expenses on both the estate's income tax return and the estate's estate tax return. Second, when estate corpus is used to pay the administration expenses (as with those estate expenses allocated to corpus in this case), that same corpus obviously cannot be used to fund the marital, charitable or any other estate tax deduction. Finally, when state law or the controlling testamentary documents create an obligation on the part of the estate to use corpus to pay those expenses, then estate corpus is viewed as actually or constructively distributed for that purpose and therefore cannot be distributed to the surviving spouse or to charity. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 33 T.C. 801, 804 (1960), *aff'd per curiam*, 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961).

The Commissioner admits that neither state law nor the controlling testamentary documents create any obligation to pay post-death administration expenses from Estate corpus. (CIR Br. at 8.) Instead, the Commissioner attempts to fashion a new

9. No dollar of double deduction occurs here either factually or legally. In addition to the factual symmetry, the language of this no-double deduction rule limits its application to amounts deductible under §§ 2053 (administrative expenses and debts) and 2054 (losses); the rule has no application to amounts deductible from the taxable estate under §§ 2055 (transfers to charity) and 2056 (transfers to surviving spouse).

limitation: after 40 years, she now says that § 2056(b)(4)(B) preempts state law governing property rights and the value of the corpus passing to the widow. That statute, says the Commissioner, provides that when post-death administration expenses are paid out of post-death income as permitted by Georgia law and the controlling testamentary documents, the expenditure of that income constitutes an "obligation" or "encumbrance" on the surviving spouse's right to income, the effect of which is to require a dollar-for-dollar reduction of the value of the corpus passing to the surviving spouse.

As to the Estate corpus passing to charity in this case, the Commissioner also admits that corpus bears no obligation under state law or the testamentary documents to pay post-death administration expenses. Nevertheless, the Commissioner fashions a non-statutory limitation on an estate's charitable deduction by contending that the Estate corpus is subject to some amorphous "obligation" to pay post-death administration expenses because income of the estate is used to pay those expenses. As is shown below, that conclusion rips the otherwise smooth fabric of the estate tax system.

2. Hindsight Plays No Part in Determining the Date-of-Death Value of Property Included in the Gross Estate and the Date-of-Death Value of Property Distributed to Marital and Charitable Legatees.

Ten years after Mr. Hubert's death, the Commissioner argues that $1 of administration expenses incurred and paid with income today somehow reduces the date-of-death value of the corpus in 1986 by that same $1. Consistent usage of a date-of-death valuation standard definitionally precludes such a futuristic examination to determine date-of-death value. Hindsight, as a valuation tool, would undermine the fundamental nature of the estate tax as an excise tax on the value of property transferred at death. As this Court was quoted in *Walter v. United*

States, 341 F.2d 182, 185 (6th Cir. 1965):

> It also must be kept in mind that the measure of the [estate] tax must be determined according to the situation as it existed on the date of the death of the decedent, and not according to the subsequent events, '[t]empting as it is to correct uncertain probabilities by the now-certain fact . . .' [*citing Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1924)].

Accord, Trust Servs. of America, Inc. v. United States, 885 F.2d 561, 569 (9th Cir. 1989); *Estate of Lloyd v. United States*, 650 F.2d 1196, 1199 (Ct. Cl. 1981); *Estate of Gilford v. Commissioner*, 88 T.C. 38, 52 (1987).

This statutory theme of prohibition against a hindsight approach to valuation has been the decisional basis for this Court many times. As this Court held early in the life of the estate tax, income earned by an estate during its administration is not included in the gross estate, notwithstanding the fact that charity or the surviving spouse has a right to receive that income under the Will. *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941); *Bull v. United States*, 295 U.S. 247, 256-257 (1935). Symmetrically, neither the marital deduction nor the charitable deduction can then be "grossed up" by income earned during the estate's administration even though that income is actually distributed to charity or the surviving spouse. Otherwise, such values would no longer be "date-of-death." *Harrison v. Northern Trust Co.*, 317 U.S. 476, 480 (1943).[10]

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10. The examples used by the Commissioner and the Tax Court dissent suffer from this defect. (CIR Pet. at 66a, 70a; CIR Br. at 27-28.) These defects are summarized in Farhad Aghdami, *Payments Out of Post-Mortem Income: Impact on Estate Tax Marital and Charitable Deductions*, 49 TAX LAW. 707, 739-740 (1996):

(Cont'd)

As a consequence, since post-death income cannot increase

(Cont'd)

> [T]he asset Judge Halpern used in his example was a zero-coupon bond which was valued, in part, by determining the present value of the future income stream. Judge Halpern stated that since the income portion attributable to the zero-coupon bond is used to pay expenses, the marital deduction must be reduced. Assuming Judge Halpern's analysis was correct with respect to the zero-coupon bond, the same analysis does not hold true when the value of the asset is not measured by its future income stream. This point is demonstrated by the example of the $1000 certificate of deposit which has $50 of accrued income [at the date of the decedent's death]. This asset is valued in the gross estate at $1050. The income stream derived from the CD after the decedent's death is irrelevant to a determination of the value of the gross estate and the amounts of the marital and charitable deductions. At the death of the decedent, $1050 is included in the gross estate. The payment of expenses from income earned by the CD after the death of the decedent does not affect, in any way, this amount. When the CD matures, an amount of $1100 representing $1050 of principal and $50 of income is paid to the estate. The payment of a $50 administration expense from income does not, in any way, reduce or affect the principal amount of $1050.
>
> Judge Halpern's analysis fails for a second reason. When the value of an asset is measured by valuing the income stream derived from the principal, such as a zero-coupon bond, Judge Halpern stated that the marital deduction should be reduced if administration expenses are paid from the income stream. However, Judge Halpern failed to consider that the value of the asset in the gross estate, and not just the marital deduction, should be reduced to reflect the burden on the income stream.

the gross estate, neither can proper payment of estate administration expenses from post-death income decrease the amount of the estate that actually passes to charity or to a surviving spouse. To hold otherwise would contravene the statutory directive to deduct "from the value of the gross estate the amount of all bequests" to charity and to deduct "from the value of the gross estate an amount equal to the value of any interest in property which passes . . . from the decedent to his surviving spouse . . . ." §§ 2055(a), 2056(a).

3. The Holdings of the Tax Court and the Eleventh Circuit Produce the Only Result Which Is Consistent with the Purposes of the Marital and Charitable Estate Tax Deductions.

Notably, the Commissioner seeks in this case to create tax when none was intended by Congress or the decedent. To that end, the Commissioner cites the now-superseded purpose of the marital deduction of giving common law estates the same property-splitting benefits available to community property estates, in which the surviving spouse's one-half interest in the community is excluded from the decedent's gross estate by virtue of the community property system. (CIR Br. at 23.) That purpose has had no mathematical or substantive meaning since 1981. Since 1981, the purpose of the marital deduction has been entirely different. Congress chose then to recognize a married couple as a single economic unit, so that it was inappropriate to impose transfer taxes until the death of the last member of that economic unit. S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981), *reprinted* in 1981-2 C.B. 412, 461. Based upon this concept, Congress dramatically changed the federal estate tax marital deduction from the community property parity of a 50% exclusion to a 100% exclusion on the death of the first spouse. In this way, the federal estate tax burden is deferred until the closing of the economic unit — the death of the surviving spouse.

Similarly, Congress always has encouraged charity by exempting from federal estate tax all charitable contributions, recognizing that such encouragement relieves the government from meeting public needs which would fall on the shoulders of the government in the absence of charitable activity. *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972), *citing* H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938). If a citizen gives his or her entire estate to charity, the charity receives that entire estate without diminution by federal estate taxes.

Nevertheless, the Commissioner asks this Court to hold that when administration expenses are properly paid from estate income, the estate is not entitled to a charitable or marital deduction for the full amount of the gross estate that actually passes to charity and to the spouse, a departure from the congressional directive expressed in §§ 2055(a) and 2056(a) to deduct from the gross estate the date-of-death value of bequests to charity and to the surviving spouse. To illustrate, assume that the value of John's gross estate on the date of his death was $30x of corpus. During the period of estate administration, the estate earned $6x in income and incurred $4x in administration expenses. As permitted by the Will and by state law and with due regard to fiduciary duties to income beneficiaries versus remaindermen, the executor used $2x of the $30x of corpus to pay administration expenses, paying the $4x balance of the administration expenses from the $6x of post-death income earned by the corpus. Since $2x of the $30x estate corpus was used to pay administration expenses, the remaining $28x of corpus was split evenly between the surviving spouse and charity, with actual corpus distributions to each of $14x. This accounts for the entire $30x existing as of the date of death. Because the executor used $4x of the $6x post-death estate income to pay estate administration expenses, the net income of the estate was $2x, all of which was reported on the estate's fiduciary income tax returns (Form 1041). What came in, went out: the estate balanced.

In contrast, the Commissioner's position results in a hypothetical, disappearing residuary estate: despite the fact that $14x of date-of-death corpus was actually distributed to the spouse and $14x of date-of-death corpus was actually distributed to charity, the Commissioner would artificially assume that only $12x of corpus passed to each beneficiary:

	$30x	gross estate
-	2x	administration expenses paid from corpus
-	4x	expenses paid from income
	$24x	estate remaining for distribution to beneficiaries
÷	2	division of estate equally between spouse and charity
	$12x	distribution to each of spouse and charity

This view leaves $4x of corpus missing from the gross estate, yet subject to estate tax. In other words, the $30x date-of-death corpus is distributed $2x for expenses paid from corpus, $12x to the spouse and $12x to charity, for a total of only $26x. Thus, $4x of corpus disappears, but not before it is taxed.[11] This construction disregards the mandate of the marital and charitable deduction sections, which require that the full value of all property actually passing to those beneficiaries be deducted from the gross estate. §§ 2055(a), 2056(a). In order to avoid taxation of this disappearing residuary on the estate tax return, the executor is forced to move the administration expenses paid from income to the estate tax return, rather than the estate's income tax return. The resulting tax on *gross* income is an administrative repeal of the choice given to fiduciaries in

11. Worse yet, the tax on the $4x has to be paid by John's estate, which further reduces the marital and charitable deductions, which generates more estate tax, which further reduces the marital and charitable deductions, which generates more estate tax, spiraling the bequests to John's widow and charity ever downward.

§ 642(g) as to the situs of a deduction for administration expenses.[12]

"The cardinal principle of statutory construction is to save and not to destroy." *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1, 30 (1937). The deliberate congressional choice to give the executor freedom in the allocation of administration expenses as between corpus and income is inconsistent with a forced and fictional allocation of administration expenses to corpus.

For these reasons, the courts below correctly decided this case. The Commissioner's construction cannot be reconciled with the express language of the Internal Revenue Code.

4. As the Commissioner Has Argued Successfully Before, State Law Determines Property Rights.

The Commissioner, for 30 years, has taken the position that whether and how the payment of administration expenses affects estate corpus passing to the surviving spouse and charity is a question of state law. *Estate of Watts v. Commissioner,* 823 F.2d 483, 485 (11th Cir. 1987); *Alston v. United States,* 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner,* 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson,* 293 F.2d 311, 312-313 (5th Cir. 1961).

In particular, state law governs apportionment of estate expenses in the form of taxes, absent contrary provisions in the

12. As well, forcing deduction of the administration expenses on the estate tax return interferes with the fiduciary's obligation to fairly apportion expenses between corpus and income beneficiaries. By definition, according to the Commissioner, all administration expenses are chargeable to corpus, a truism which has been rejected by the courts. *Estate of Warren v. Commissioner,* 981 F.2d 776, 782 n.10 (5th Cir. 1993).

Will. *Riggs v. Del Drago,* 317 U.S. 95, 98 (1942). The apportionment of estate taxes has important consequences: it can affect the actual amount of the estate tax.[13] In this context, state law controls what portion of the estate taxes must be attributed to the surviving spouse and be subtracted in determining the marital deduction. When the Eighth Circuit addressed calculation of the marital deduction, it too held, as the Tax Court did here, that the allocation of the expense (federal estate taxes) in calculating the marital deduction is controlled by state law. *United States v. Traders Nat'l Bank,* 248 F.2d 667, 669 (8th Cir. 1957).

Ironically, the Commissioner now seeks to ignore her own success in persuading the Fifth Circuit to look to state law to determine who bears administration expenses and then to apply federal law once the flow of property is defined. The result reached by the Fifth Circuit and urged by the Commissioner in the three decisions of *Alston v. United States,* 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner,* 294 F.2d 774 (5th Cir. 1961); and *Ballantine v. Tomlinson,* 293 F.2d 311, 312-313 (5th Cir. 1961) (which are the foundation for all of the appellate court cases in this area), was absolutely correct. State property and probate law has to be considered because it, as applied to the controlling testamentary documents, dictates where the property actually flows.[14] The parties have stipulated here that the property flows precisely where and how Mr. Hubert's Estate says it flows. The Commissioner now, however, seeks to abandon the

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13. An apportionment of estate taxes to a marital or charitable share decreases the amount of the deduction and thus increases the estate taxes due. Such a determination under state law is a determination of the underlying rights of the parties upon which the amount of the federal estate taxes depends.

14. The stipulation of the parties is that state law and the testamentary documents control the distributions of property in Mr. Hubert's Estate. (Jt. App. at 34 ¶ 40.)

well-established bodies of state property and probate law, which every state has, in favor of a non-existent body of federal property and probate law, even though the Commissioner championed that state law when it worked to her financial advantage in the three cited cases.[15] Mr. Hubert's Estate embraces the proposition of these cases that when administrative expenses are required by the Will or state probate law to be paid from corpus, or when the executor actually elects to pay such expenses from corpus, then the charitable and marital deductions must be reduced to reflect what those beneficiaries actually receive, as required by §§ 2055(a) and 2056(a). In fact, the court which issued these three foundational decisions has remained true to that proposition.

Estate of Warren v. Commissioner, 981 F.2d 776 (5th Cir. 1993), recognizes the controlling effect of state law on the precise issue presented here. In *Warren* the decedent's Will placed the bulk of her estate into two equal charitable lead residuary trusts. As here, Will contests were filed, and the charities filed a suit for a declaratory judgment as to how the administration expenses of the estate should be allocated between corpus and income. A settlement was reached. The administrators of the estate then asked the probate court for instructions regarding allocation of administration expenses, because, under the Texas Trust Code (like Georgia law), expenses could be charged against either income or principal. The probate court ordered that a reasonable allocation of the expenses would be 72.5% to income and 27.5% to corpus. Pursuant to that holding, the estate deducted 27.5% of the expenses on its estate tax return (Form 706) and the balance on its income tax returns (Forms 1041) — a ratio virtually identical to the ratio in this case.

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15. "[T]he rule is the rule whosoever's ox is being gored . . . [O]ur job is to assure that what was once the goose's sauce shall for the gander now be the same." *Neill v. Phinney,* 245 F.2d 645, 647 (5th Cir. 1957).

The Commissioner claimed in *Estate of Warren,* as here, that all the expenses were chargeable to corpus and none could be allocated to income. On that basis, the Commissioner reduced the charitable deduction dollar-for-dollar. However, the Fifth Circuit held that the probate court had applied state law properly in allocating the administration expenses between income and corpus and that, as a result, the administration expenses charged to income and deducted on the income tax returns did not reduce the charitable deduction. 981 F.2d at 782.

For these reasons, the Commissioner misconstrues the relationship between federal law and state law as it applies to this case. State law determines the rights and interests of the parties, while federal law determines how these interests are taxed. *Morgan v. Commissioner,* 309 U.S. 78, 80-81 (1940); *Blair v. Commissioner,* 300 U.S. 5, 9-10 (1937). Nevertheless, the Commissioner here asserts that state law should be read out of the equation whenever there is a possibility that differing results could be reached depending upon the residence of the decedent. (CIR Br. at 31-33.) This simply is not the law.[16] Whenever state law defines property and probate interests differently, the estate tax regime necessarily follows those interests, and results differ. *See, e.g., Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967); *Jackson v. United States,* 376 U.S. 503 (1964); *Estate of Vissering v. Commissioner,* 990 F.2d 578 (10th Cir. 1993); *Estate of Warren,* 981 F.2d at 776; *Estate of Casey v. Commissioner,* 948 F.2d 895 (4th Cir. 1991); *United States v. Edmondson,* 331 F.2d 676 (5th Cir. 1964); *United States v. Traders Nat'l Bank,* 248 F.2d 667, 668 (8th Cir. 1957); *Hunter v. United States,* 597 F. Supp.

16. There is nothing in the Internal Revenue Code or the regulations thereunder that requires administration expenses to be paid out of corpus. *Estate of Warren,* 981 F.2d at 782 n.10. As the Commissioner admits, nothing in Georgia law requires administration expenses to be paid out of corpus. Consequently, there is no conflict between state and federal law — either on the merits or the 30-year history of federal law looking to state law with respect to the determination of property rights.

1293 (W.D. Pa. 1984); *Estate of Bennett v. Commissioner,* 100 T.C. 42, 67 (1993); *Estate of Watson v. Commissioner,* 94 T.C. 262 (1990); *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987); *Estate of Snider v. Commissioner,* 84 T.C. 75 (1985); *Estate of Lee v. Commissioner,* 11 T.C. 141, 145-148 (1948), *acq.,* 1948-2 C.B. 3.

The Commissioner's dance to a new tune is apparent from a review of her guidance to the public. The nationwide ruling position of the Commissioner for the past 30 years has been that these matters are controlled by state law. For example, Rev. Rul. 66-21, 1966-1 C.B. 219, held that only one-half of a decedent's funeral expenses were allowable as a deduction under Texas community property law, which made half those expenses an obligation of the surviving spouse. In response, Texas changed its law, and the Commissioner accordingly ruled that funeral expenses paid after May 26, 1967 for a Texas decedent were fully deductible. Rev. Rul. 69-193, 1969-1 C.B. 222; *accord,* Rev. Rul. 76-369, 1976-2 C.B. 281. Those rulings remain in force today. Likewise, in Rev. Rul. 78-419, 1978-2 C.B. 244, and Rev. Rul. 88-12, 1988-1 C.B. 330, the Commissioner held that South Carolina law determined whether expenses and federal and state death taxes were chargeable to the marital share. The Commissioner stated (*id.* at 331; emphasis added):

> In ascertaining the net value of the interest passing to the surviving spouse for purposes of determining the allowable marital deduction, *applicable state law is determinative of the extent* to which federal and state death taxes and *debts and expenses are chargeable against the spouse's interest.*

The long history of state law determination of this issue is appropriate because this is not an issue upon which a federal

uniform standard is necessary. Congress, in drafting the Internal Revenue Code, did not intend to redefine whole areas of legal relationships created by state property law but instead sought to impose a uniform system of taxation upon the existing legal structure. *Morgan v. Commissioner,* 309 U.S. 78, 80-81 (1940); *Ernest & Mary Hayward Weir Foundation v. United States,* 362 F. Supp. 928, 932 (S.D.N.Y. 1973), *aff'd,* 508 F.2d 894 (2d Cir. 1974).

The Commissioner's attempt to substitute federal law for state law is particularly inappropriate when, as with property and probate matters, the body of state law is well developed and the body of federal law is not. As recognized in Note, *The Role of State Law in Federal Tax Determinations,* 72 HARV. L. REV. 1350, 1353 (1959) (emphasis added):

> One factor operating in favor of the application of state law is the advantage of convenience and predictability in planning. Most lawyers are accustomed to operating within the framework of *state property and probate law,* and this law is generally more settled than the comparatively recent and shifting tax legislation. If tax consequences follow local law, therefore, the tax consequences of property dispositions will be more predictable.

Thus, federal law is presumed *not* to preempt state law in inherently local areas of the law such as property rights and probate matters. *Cf., California v. FERC,* 495 U.S. 490, 497 (1990); *California v. ARC America Corp.,* 490 U.S. 93 (1989); *Paige v. Henry J. Kaiser Co.,* 826 F.2d 857 (9th Cir. 1987), *cert. denied,* 486 U.S. 1054 (1988).

Accordingly, judicial precedent, the Commissioner's own rulings, commentary,[17] and the facts of this case all support the Tax Court's recognition of substantive property rights under Georgia law. The alternative now urged by the Commissioner would create a schism between a federal fiction and the actual distribution dictated by the controlling documents and Georgia law. Uniformity of tax treatment following substantive state law would be sacrificed in favor of schisms that would vary in breadth from state to state. *Commissioner v. Stern,* 357 U.S. 39, 45-47 (1958) (constitutionally required uniformity exists even though variations in state law result in differences in tax consequences from state to state).

5. No Difference Should Exist Between an Estate Which Is Able to Promptly Distribute Its Assets into Trust and One Which Is Not.

At least one commentator has pointed out that the treatment

17. Since the Tax Court issued its thorough decision, seven of the eight articles which take a position on this issue have agreed with the Tax Court and the Eleventh Circuit. Farhad Aghdami, *Payments Out of Post-Mortem Income: Impact on Estate Tax Marital and Charitable Deductions,* 49 TAX LAW. 707 (1996); Pamela C. Champine, *Paying Administrative Expenses Out of Income Attributable to Marital and Charitable Residuary Bequests: Double Dipping or Appropriate Accounting?,* 14 VA. TAX REV. 507 (1995); Steven C. Colburn, Ted D. Englebrecht & Gloria Vollmers, *Administrative Expenses and the Marital Deduction,* 72 TAXES 412, 419 (1994); Scott H. Malin & Bennett S. Keller, *Planning for the Allocation of Administration Expenses to Income Under Hubert,* 84 J. TAX'N 213 (1996); David Pratt, *Deducting Estate Administration Expenses: Does a Section 642(g) Election Still Make Sense?,* 65 TAX NOTES 1683, 1688 (1994); Jacques T. Schlenger, Robert E. Madden & Lisa H.R. Hayes, *Administration Expenses Payable from Income Do Not Reduce Marital and Charitable Deductions,* 23 EST. PLANNING 30 (1996); George L. Strobel II & Caroline D. Strobel, *The Proper Treatment of Administrative Expenses: The Debate Rages On,* 27 TAX ADVISER 228, 233 (1995). *Contra,* Student Note, *Tax Law: Administrative Expenses and the Charitable and Marital Deductions — The Potentially Painful Surprise of a 642(g) Deduction — Estate of Hubert v. Commissioner,* 20 U. DAYTON L. REV. 501 (1994).

reported by the Hubert Estate is precisely the same treatment the Commissioner would require had the Estate been able to promptly close into trust. Jeffrey N. Pennell, 843 TAX MGMT. ESTATE TAX MARITAL DEDUCTION at A-30 (BNA 1996). Applying Professor Pennell's test, if the Hubert Estate had been able to close immediately into trusts, the marital and charitable trusts would simply report income and expenses on the trust's fiduciary income tax returns, using the same forms and numbers used here. On these facts, the Estate could have no estate tax due, providing symmetry by fully accounting for the date-of-death corpus in distributions which qualified for the marital and charitable estate tax deductions. In turn, the true net income of the estate — the post-death income and administration expenses paid therefrom — would be reported by the trusts on the fiduciary income tax returns. That result cannot be changed without doing violence to the date-of death valuation regime merely because the estate administration is delayed.

Professor Pennell's analysis demonstrates that the Commissioner's position confuses the realities of estate administration with the date-of-death valuation rules. There is simply no justification for subjecting a delayed estate to different estate tax valuation treatment than one which is fortunate enough to close promptly.

6. Neither the Case Principally Relied Upon by the Commissioner in This Court, *United States v. Stapf*, nor Reg. § 20.2056(b)-4(b) Requires that Authorized Payments of Administration Expenses from Post-Mortem Income Reduce the Marital and Charitable Deductions Dollar-for-Dollar.

In addition to the three Fifth Circuit decisions in which the Commissioner successfully urged the Fifth Circuit to consider state law in determining whether the corpus bore the obligation to pay post-mortem administration expenses, the Commissioner

relies upon two authorities to create the disappearing residuary needed to produce a tax liability here. Both are unworthy of reliance.

a. The Commissioner Places Her Principal Reliance Upon a "Real Value" Argument Derived from *United States v. Stapf*, Which Does Not Relate to This Area of the Law.

For the first time in the eight-year history of this case, the Commissioner raises a "real value" argument derived from *United States v. Stapf*, 357 U.S. 118 (1963), and places her primary reliance on that argument. (CIR Br. *passim*.) According to the Commissioner, "real value" means that the date-of-death value of the property passing to either the widow or the charities can be valued only by reducing the value of corpus dollar-for-dollar by all post-mortem administration expenses paid out of post-mortem income.

Strangely, the Commissioner did not cite this case for this or any other proposition in her Petition for Writ of Certiorari. Nor was this case cited for this or any other proposition by the majority or the dissenting opinion in the Eleventh Circuit. And it was not cited for this or any other proposition by the majority or either of the two dissenting opinions in the Tax Court. The reason is that *Stapf* does not relate to this area of the law.[18] *Stapf*

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18. Although the Commissioner did not see fit to mention *Stapf* in her Petition for Writ of Certiorari, *Stapf* is now the authority upon which the Commissioner claims other courts of appeals relied in rejecting the Estate's position prior to the Eleventh Circuit's opinion below, including *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 510 U.S. 990, (1993); *Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir. 1961); and *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992). (CIR Br. at 20.) The Commissioner overstates the case. A quick review of the pre-*Estate of Hubert* cases reveals that: (a) the *Burke* court did not follow, cite or even mention

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is a *quid pro quo* case in which this Court recognized that the wife effectively purchased her interest from the estate by agreeing to transfer another interest she held to the children. It has nothing to do with post-mortem administration expenses or post-mortem income or their impact on date-of-death value. Moreover, the "real value" principle the Commissioner extracts from *Stapf* yields results that can only be described as startling.

Consider the arithmetic application of this "real value" position in the context of an example. Assume that John develops a computer modem that, on the day of his death, has a stipulated value of $5 million. His executor handles the administration of the estate in a reasonable manner but, on the eve of the expected closing of the estate, massive litigation is filed over the royalties generated by the modem. Years pass and $5 million of expenses are incurred before the litigation is resolved. Fortunately, the modem has been generating more than enough income to pay those expenses, and the Will and state probate law permit the payment of those post-mortem expenses out of this post-mortem income. The estate is then closed and the rights in the modem are, pursuant to John's Will, evenly divided between his widow and his favorite charity. At the time of the distribution, the modem rights now have a value of $10 million. According to the Commissioner, what is the date-of-death "real value" of those modem rights passing to the widow and the charity which were worth $5 million and are now worth $10 million? Zero.

To be precise, the Commissioner's *Stapf* position, coupled with her construction of the permissive example in her valuation

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Stapf; (b) the *Ballantine* court could not have relied upon *Stapf* since *Ballantine* predated *Stapf* by two years; and (c) *the Estate of Street* court cited *Stapf* only as a "*see, e.g.,*" cite, with no analysis whatsoever. Instead, the *Estate of Street* court placed its primary reliance on *Estate of Roney v. Commissioner*, 294 F.2d 774 (5th Cir. 1961), another decision which predates *Stapf*.

regulation, is that the "real value" is $5 million as of the date-of-death for estate tax inclusion purposes, but the "real value" of the same property on the same day is zero for distribution purposes because the value is somehow reduced dollar-for-dollar by any post-mortem expenses ever properly paid out of post-mortem income. Why? Because it allows the Commissioner to create a disappearing residuary and thereby collect over $2.5 million in taxes when none were intended by Congress.

The Commissioner presses this position by equating her fictional offset against the value of corpus with an actual reduction. She must resort to a federal fiction because the Commissioner admits that state law imposes no obligation on this corpus. Yet, fiction is not enough.

Throughout her brief, the Commissioner argues that discretion given to an executor by state law and in a Will to pay administration expenses from either corpus or income constitutes an "obligation" or "encumbrance" upon the date-of-death value of the property passing to the surviving spouse and to charity, without regard to the source of funds used to pay the administration expenses, and that § 2056(b)(4)(B) thus requires a reduction of the marital and charitable deductions. (CIR Br. at, *e.g.*, 16-19.) In attempting to force this issue into the *Stapf* mold, the Commissioner reads too much into both the statute and *Stapf*.

Just as in *Stapf*, § 2056(b)(4)(B) applies to instances in which the property of the decedent does not "pass" to the surviving spouse under the Will but instead is "purchased" by the surviving spouse. Thus, for example, if the spouse must retire a mortgage against property left to her in her husband's Will, that portion of the gross value of the property burdened by the mortgage does not "pass" to her under the Will, but instead she "pays" for it by retiring the mortgage. If the spouse must pay $5000 to the decedent's sister in order to take property under the Will, that property "costs" her $5000. Reg. § 20.2056(b)-4(b),

exs. 1 & 2. As well, § 2056(b)(4)(B) "obligations" or "encumbrance" exist as of the date of death. In contrast, when administration expenses are properly paid out of income, every dollar of corpus in the marital bequest which is in existence on the decedent's death actually passes to the surviving spouse. She incurs no "cost" in taking that date-of-death value, nor does she "pay" for it.

The Commissioner admits that administration expenses in the form of interest on estate taxes do not reduce the marital deduction. Like other administration expenses, this interest is unknown at the date of death and is thus not owed as of the date of death. It thus does not alter the date-of-death value of property passing to charity or to a surviving spouse when that interest expense is paid with estate income rather than corpus. Rev. Rul. 93-48, 1993-2 C.B. 270, *adopting the interest expense holdings in Estate of Street v. Commissioner,* 974 F.2d 723 (6th Cir. 1992), and *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987).

This analysis for interest on estate taxes is a recognition of the role of §§ 2055(d) and 2056(b)(9), which preclude a charitable or marital deduction for amounts deducted under another section. Administration expenses, if and when deducted on an estate tax return and thus allocable to estate corpus, are deducted under § 2053(a)(2). When not deducted on the estate tax return and not paid from estate corpus, no diminution to the date-of-death value of property actually received by charity and the surviving spouse occurs. In short, the rule is simply that administration expenses deducted on the estate tax return necessarily reduce the value of the bequest which provides the corpus to pay those expenses and thus reduce the charitable or marital deduction. §§ 2055(a), 2056(a). When administration expenses are properly paid out of income and thus are not allocable to corpus, the full date-of-death value of that corpus is actually received by charity or the surviving spouse so that no diminution of the charitable or marital bequest may occur

without disregarding § 2055(a)'s and § 2056(a)'s directives that property actually received by charity and the surviving spouse pass free of estate tax.

Further, as the courts below held, § 2056(b)(4)(B) has no application to proper payment of administration fees from post-death income for two additional reasons: (a) under the Commissioner's estate and gift tax regulations and rulings expressly invoked by § 2056(b)(4)(B), the payment of trustee fees and administration expenses results in no diminution of corpus passing to the spouse; and (b) the Commissioner's new interpretation of a permissive example in Reg. § 20.2056(b)-4(a) is entitled to no deference from this Court. Mr. Hubert's Estate will address these in turn.

b. Under the Commissioner's Gift and Estate Tax Regulations and Rulings, Which are Expressly Invoked by § 2056(b)(4)(B), Payment of Administration Expenses Does Not Result in a Diminution of Corpus Passing to the Spouse.

The language of § 2056(b)(4)(B) requires that the effect of any encumbrance on value be determined as if a gift in trust to the spouse had been made. However, the Commissioner's argument characterizing payment of administration expenses from income as an "obligation" or "encumbrance" within the meaning of § 2056(b)(4)(B) ignores the very regulation written to speak to that issue. In fact, Reg. §20.2056(b)-5(f)(4) explicitly condones the power to determine the allocation of receipts and disbursements between income and corpus. That regulation addresses the marital deduction when, as is the case here, the surviving spouse receives a life estate with a general power of appointment.[19]

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19. Under the Second and Final Settlement Agreement, the Marital Share is divided between the GPA (general power of appointment) Trust and the QTIP Trust. Reg. §20.2056(b)-7(d)(2) incorporates these same principles with respect to the QTIP Trust.

The gift tax rule applicable in this situation, Reg. § 25.2523(e)-1(f), entitled *Right to Income,* interprets the requirement of § 2523(e) that a gift in trust to a spouse does not qualify for a gift-tax-free transfer to that spouse unless the donee spouse is "entitled for life to all of the income." In interpreting that requirement, the Commissioner's regulations make it clear that the requisite condition is met (Reg. § 25.2523(e)-1(f)(1)):

> if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. . . .

The regulation then parallels Reg. § 20.2056(b)-5(f)(4) by providing that the trustee's ability to allocate expenses as between income and corpus has no effect on the spouse's "beneficial enjoyment" if that choice is policed by the fiduciary obligations of the trustee to the spouse as income beneficiary (Reg. § 25.2523(e)-1(f)(4) (emphasis added)):

> (4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest transferred in trust [for want of entitlement to all of the income] unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations

> will not disqualify the interest transferred in trust are *the power to determine the allocation or apportionment of receipts and disbursements between income and corpus.* . . .

The regulation notes that a spouse will be deemed to have received all of the income even if "trustee's commissions and other charges," all of which are administration expenses, are paid out of that income. Reg. § 25.2523(e)-1(f)(3). This, of course, is consistent with the proposition that an income beneficiary has no right to "gross income," but must pay his or her fair share of expenses.

Moreover, the Commissioner's estate tax regulations reach the identical conclusion when, as here, the surviving spouse receives a life estate with a general power of appointment. Those regulations provide that the surviving spouse "'is entitled for life to all of the income from the entire interest' . . . if the effect of the trust is to give her substantial . . . beneficial enjoyment. . . ." Reg. § 20.2056(b)-5(f)(1). The regulations then restate the exact language just quoted in the gift tax rules, concluding that if local courts impose reasonable limitations upon a trustee's exercise of fiduciary duties, the marital deduction will not be disqualified even though the trustee has "the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . ." Reg. § 20.2056(b)-5(f)(4).[20]

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20. The year before Mr. Hubert died, the Georgia Supreme Court recognized such duties and limitations in a case involving the same trustee as in the Hubert Estate. *Citizens & Southern Nat'l Bank v. Haskins,* 254 Ga. 131, 327 S.E. 2d 192, 201 (1985) ("[w]hile there are rules for categorizing items as income or principal, the settlor may authorize the trustee to allocate interests to income which would otherwise be principal and vice versa. . . . When exercising this power the trustee must "act impartially as between income and principal beneficiaries").

Having thus set forth the fact that payment of administration expenses from income has no effect on the mandatory gift tax requirement that a spouse have a right to "all of the income," the Commissioner thereby has established that proper payment of administration expenses from income can have no effect on the net value of assets received by charity or the surviving spouse. Thus, the statute's requirement has been met that the "encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." § 2056(b)(4)(B). In fact, the Commissioner has so ruled. In Rev. Rul. 69-56, 1969-1 C.B. 223, 224, the Commissioner wrote (emphasis added):[21]

> To charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses . . . *does not result in the* disallowance or *diminution of the marital deduction.*

This construction of § 2056(b)(4)(B) is the only one which

21. The Commissioner attempts to distinguish this ruling by arguing that the ruling addressed only whether "the inclusion of [discretionary powers to charge administration expenses to corpus or income] in the governing instrument" would result in the diminution of the marital deduction. The Commissioner then asserts that the ruling did not purport to address whether actual payment of administration expenses out of corpus or income would require a diminution of the marital deduction. (CIR Br. at 26 n.8.) This distinction is nonsense. The Commissioner is stating that she issued a hypothetical ruling which could never have effect — she states that she ruled that discretionary language in a Will produces no diminution of a marital deduction when the Will is written, but does so when the testator dies. This argument ignores the fact that a Will has no operative effect until death, nor is a marital deduction determined until death. In fact, the cited ruling is directly applicable to the valuation of property passing to the surviving spouse, because the valuation issue does not arise until death.

harmonizes the long-standing promulgations of the Commissioner in the form of regulations and rulings. In those pronouncements, the Commissioner has conceded that payment of expenses out of income does not constitute a "material limitation" on the spouse's right to the full value of the property, with the result that the full date-of-death value qualifies for the marital deduction. She has done so because no other conclusion is consistent with the statutory language.

c. The Commissioner's New Interpretation of a Permissive Example in a Valuation Regulation Is Entitled to No Deference from This Court.

In valuing the marital deduction, the Commissioner interprets a permissive example set forth in her regulations as setting forth an unbending rule, then asks this Court to apply the normal deference given to interpretive regulations to the Commissioner's incongruent interpretation, as opposed to giving deference to the text of the regulation itself. Reg. § 20.2056(b)-4(a). (CIR Br. at 27-29.) However, the only deference to which the regulation is entitled is for matters to which the regulation addresses itself.

The Tax Court majority correctly concluded that the allocation of post-death expenses to post-death income is a *valuation* matter under the regulation, as opposed to an obligation or encumbrance issue. (CIR Pet. at 40a.) The caption of the regulation, the first sentence, the example sentence and every other operative sentence speak to *value*. Moreover, this regulation is an interpretive regulation of a valuation statute, § 2056(b)(4), captioned "Valuation Of Interest Passing To Surviving Spouse."

There are many more reasons why the Tax Court declined to give deference to the Commissioner's mandatory interpretation of her valuation example. First, the example is stated in terms of

"may," which is classic permissive language. *Guilzon v. Commissioner,* 985 F.2d 819, 823 (5th Cir. 1993)); *Brimberry v. Commissioner,* 588 F.2d 975, 977 (5th Cir. 1979).[22]

Second, the example fails to state whether the executor was required by the Will or by state law to pay administration expenses with corpus. To the extent either is the case, of course, the value of the property passing to the spouse would be diminished. Indeed, the lack of any instruction in the example may well explain the use of the permissive "may," for if the executor were not so required, the fact of such a liability could not be known as of the date of death and there could be no diminution in that value.

Third, the "may" language is consistent with the fact that any permitted allocation of administration expenses between corpus and income post-death cannot be predicted without knowing what will occur during the process of administration. Since the allocation necessarily will be made with a fine eye to the adverse rights of the various parties, it is completely dependent upon events which are not known and not knowable at the date of death.

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22. Based upon various factual constructs, there was good reason for the Commissioner to phrase this example in permissive terms. In situations such as in *Alston, Estate of Roney* and *Ballantine*, the example is correct. Burdening the surviving spouse's right to income with expenses that are the legal obligation of the corpus-beneficiary is a material limitation. In other situations, such as in *Estate of Warren*, the permissive example would not apply because the post-mortem income is only burdened with its fair share of the post-mortem expenses and a surviving spouse only has a right to net income. Hence, there would be no limitation — material or otherwise — on the right to income. All manner of variations on materiality may exist between *Estate of Warren* on the one hand and *Alston, Estate of Roney* and *Ballantine* on the other. Indeed, the Commissioner has successfully urged that the effect of expenses paid out of post-death income varies with the facts. *Republic Nat'l Bank of Dallas, Trustee, v. Commissioner,* 334 F.2d 348,350 (5th Cir. 1964).

Fourth, before a testamentary provision may become a "limitation" under the regulation, before a "limitation" may become "material," and before the "effect" of any material limitation can be gauged, the spouse must have a "right to income." Without a "right to income," the regulation, by its own terms, has no application. "Right to income" implies an enforceable right. Nothing in federal, state, or common law bestows upon a spouse an enforceable, or even an equitable, "right to *gross* income." Yet, contrary to her regulations defining "Right to Income," that is precisely the import of the Commissioner's argument: any impingement on the future gross income of the spouse results in a dollar-for-dollar set off against the date-of-death value of the corpus. In other words, when an executor, trustee, or other fiduciary is faced with the question of how to allocate post-death expenses between corpus and post-death income, he or she — according to the Commissioner — is committing a *per se* violation of the income beneficiary's "right to income" if a penny of those administration expenses is borne by income. The corollary of the Commissioner's argument is that a fiduciary must thereby violate the rights of the corpus beneficiary in order to satisfy the alleged right of the spouse to *gross* income.

Finally, as the courts below recognized, the Sixth Circuit has applied the Commissioner's new interpretation of her 40-year-old regulation in an inconsistent manner. *Estate of Street v. Commissioner,* 974 F.2d 723, 729 (6th Cir. 1992), holds that one administration expense — interest on estate taxes — paid out of income does not decrease the marital deduction. 974 F.2d at 728, *citing Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987). As the Tax Court held, however, there is no rational distinction (CIR Pet. at 47a):

> In addition, administration expenses and interest on taxes cannot be distinguished according to the time at which they both

> accrue. Both accrue after the date of death. Administration expenses, by their very nature, are incurred over the entire period of the estate's administration and can vary significantly from estate to estate. As a result, administration expenses are too uncertain at the date of death to accrue at that time. Our analysis in *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987), therefore applies to administration expenses as well as to interest on taxes, and we will follow our holding in that case.

Nevertheless, the Commissioner agrees with the *Estate of Street* court that interest on estate taxes does not reduce the marital deduction, but divorces that interest from other administration expenses. Rev. Rul. 93-48, 1993-2 C.B. 270.[23]

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23. Both the Sixth Circuit in *Estate of Street* and the Commissioner here rely on S. Rep. No. 1013, 80th Cong., 2d Sess. II-6, *reprinted in* 1948-1 C.B. 331, 335. However, that legislative history addresses claims, not administration expenses. Unlike administration expenses, all the events fixing a claim have occurred at the date of death, and the claim exists in a finite amount at that time. Further, the underlying assumption of the Committee Report is that the claims are necessarily a burden on the residuary corpus and therefore the payment of those expenses out of income decreases the residuary corpus passing to the spouse. In comparison, administration expenses are unknown at the date of death and may relate to either income or corpus. The cornerstone of *Estate of Street* and *Fisher v. United States*, 28 Fed. Cl. 88 (1993) (which merely follows *Street*), is the conclusion that the principal of the estate was unequivocally burdened with these administration expenses at the date of death. This simply was not true under applicable state law and the governing instruments.

As well, in *Burke v. United States,* the Federal Circuit conceded that state law governs the determination of property rights. Indeed, the controlling state law in *Burke* required the payment of expenses out of corpus and thereby

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For these reasons, the Commissioner's regulatory example is not black letter law. Her argumentative interpretation of her permissive example as mandating an unwavering rule is entitled to no deference whatsoever.

7. The Tax Court's Fact Findings Preclude an Examination of the Legal Issue Raised by the Commissioner.

The courts below properly rejected the Commissioner's unsupported thesis that as a matter of law, administration

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forced the same ultimate conclusion reached by the Federal Circuit in *Burke*. *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied,* 510 U.S. 990 (1993). However, the *Burke* court framed the "pertinent question" as "whether payment of administration expenses must be accounted for in computing the value of a taxable estate under federal law for federal estate tax purposes regardless of the actual source of payment." 994 F.2d at 1580. This completely confuses the issue. Neither the marital share nor the charitable share are paid out of the "taxable estate." The relevant inquiry is not what is the taxable estate, but what is the residuary corpus payable to the marital share and the charitable share, which forms the marital and charitable deductions based on date-of-death values.

This misconception of the court in *Burke* leads to an asymmetrical result when expenses are properly charged to and paid from income and the executor elects to claim the administration expenses as an income tax deduction rather than as a deduction in reaching the taxable estate. As one respected commentator has noted:

> In confusing the amount actually passing to the charity and computation of the federal gross and then taxable estates, the court in *Burke* revealed that it had hardly a clue what was involved in the case. . . .

Jeffrey N. Pennell, 843 TAX MGMT. ESTATE TAX MARITAL DEDUCTION at A-30 (BNA 1996). The court of appeals here was more astute.

expenses reduce the marital and charitable deductions dollar-for-dollar, even when those expenses are paid out of estate income, as permitted by the Will and state law. (CIR Br. at 27-28.) However, the measuring concept of "value" is inherently a question of fact.[24] Thus, any effect of payment of administration expenses from income on the value of property passing to the surviving spouse and to charity is a question of fact. *Estate of Roney v. Commissioner,* 33 T.C. 801,804 (1960)("[a]s we see it, the problem [of the impact of administration expenses on the marital deduction] is essentially one of valuation— *i.e.,* what was the value of the property passing to the wife at the time of decedent's death"), *aff'd,* 294 F.2d 774 (5th Cir. 1961).

This dollar-for-dollar absolutism is inconsistent with the statute on which the Commissioner relies, § 2056(b)(4)(B). The marital deduction statute directs that "such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." In interpreting this statute, for over 40 years, the regulations have provided "[i]n determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. . . ." Reg. § 20.2056(b)-4(a). In "taking account" of any "material limitations upon her right to income from the property," no guidance is given other than the willing buyer-willing seller standard implicit in the concept of

24. Indeed, the Commissioner has consistently defined "value" as follows (Reg. §20.2031-1(b)):

> Value of property . . . is its fair market value at the time of the decedent's death. . . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller . . . both having reasonable knowledge of relevant facts. . . . All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

valuation. Thus, a trial court would be charged with determining, based upon proof presented at trial, (i) whether the contingent possibility that an unknowable amount of administration expenses could be paid from estate income constituted a "material limitation" upon her right to income from the property, (ii) if so, whether that material limitation reduced the value of the property passing to the spouse or to charity, and (iii) if so, the amount of the reduction in value. No proof on any of these factual issues was presented at this trial by the one party charged with the burden of proof — the Commissioner.

Further emphasizing the factual nature of the valuation inquiry, the gift tax rules referenced by the marital deduction statute identify even more valuation issues. For example, Reg. §25.2523(e)-1(f) provides that a spouse will be deemed to have received all income even if administration expenses are paid out of that income, provided the spouse is not deprived of the "substantial beneficial enjoyment" of the income. Thus, whether or not a deprivation of "substantial beneficial enjoyment" exists is a question of fact.[25] Once again, no factual evidence was presented on this issue by the Commissioner, who bore the burden of proof on this issue.

25. Other fact issues appear as well. For example, how can one identify without the assistance of a qualified appraiser the effect on corpus at today's fair market value of a chance of an indeterminable amount of expense which may be paid out of income five years hence? And what is the likelihood of that chance event taking place? Is that a limitation and, if so, is it material? If it is material, what is the effect? Finally, the statute, § 2056(b)(4)(B), directs that the encumbrance or obligation "shall be taken into account" as if a gift to a spouse were being valued. That phrase is used by Congress in estate tax valuation statutes and by the Commissioner in the underlying valuation regulations interchangeably with its plain meaning of "shall be taken into consideration," *i.e.*, it is purely a factual matter, requiring proof at trial. E.g., consider § 2031(b); Reg. § 20.2031-1(b); Reg. § 20.2031-2(f). In no event has "shall be taken into account" been considered to be a dollar-for-dollar limitation, as a matter of law, for a contingent obligation or encumbrance.

On questions of fact, the trial court's fact findings can be set aside only if clearly erroneous. § 7482(a)(1). In the decision in the court below, the Tax Court held (CIR Pet. at 41a):

> On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. . . . [T]he income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. Therefore, she is not deprived of substantial beneficial enjoyment, and she would be treated . . . as having received all of the income from the trust. If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income.

The Commissioner has not appealed this fact-finding, nor can she, in light of her stipulations and her failure to introduce evidence to the contrary in accordance with her burden of proof. Thus, without regard to any academic interest in the legal question posed by the Commissioner, no factual predicate exists to merit the legal inquiry. *See* Jt. App. at 42-44. As a consequence, no decision reached by this Court can have any impact on the estate tax due by Mr. Hubert's estate.[26] U.S.

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26. The Commissioner's calculations to the contrary are: (a) contradicted by the binding Stipulations; and (b) outside the record. The Commissioner thereby attempts to do in this Court what her burden of proof required her to do in the Tax Court. (CIR Reply to Br. in Opp. to Pet. for Cert. at Addendum.) Not having had an opportunity to test that calculation via cross-examination, as would be possible if the Commissioner had even tried to carry her burden of proof in the Tax Court, the Estate can nevertheless point out

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CONST. art. III, § 2, cl. 2 (no advisory opinions); 28 U.S.C. § 2201 (no declaratory judgments in tax cases such as this one); 28 U.S.C. § 2111 (no reversal based upon harmless error); *Williams v. Zbaraz*, 448 U.S. 358, 367 (1980)(moot issues); *St. Pierre v. United States*, 319 U.S. 41 (1943).

CONCLUSION

The result reached in the reviewed decision of the Tax Court and affirmed by the Eleventh Circuit is factually, procedurally, and substantively correct. The judgment of the court of appeals should be affirmed.

Respectfully submitted,

DAVID D. AUGHTRY
SHELLEY CASHION
DAVID W. SIEGEL
ATTORNEYS FOR RESPONDENT

AUGUST 1996

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obvious flaws in the calculation. First, it refers to the value of the gross estate from the tax return itself. However, as stipulated by the parties, the gross estate is $30,254,219, not $30,263,421. (Jt. App. at 39, ¶ 50.) As well, the Commissioner's stipulated marital deduction is $14,744,138 and her stipulated charitable deduction is $14,938,386, not the $12,525,143 and $12,042,434 numbers listed. See stipulations referenced at 7-9, *infra*. Based upon those stipulations, the unified credit completely shields this Estate from any estate tax liability, without regard to the other numbers contained in the Commissioner's calculation.